

Sovereign pari passu clauses: lost rights or last rites?

In late 2012, the New York courts decided that a *pari passu* clause in a sovereign bond prevented the sovereign from paying other creditors without paying the bondholders at the same time. This caused concern in some quarters, not least because of the power it offered holdout creditors in sovereign debt restructurings. Four years later, the position may have changed. A New York court has now held that the same sovereign's payments to other creditors do not breach the same *pari passu* clause. Instead, more egregious behaviour - in substance, subordinating the bonds - is, it seems, required.

"The second sentence "[t]he payment obligations... shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness" prohibits Argentina, as bond *payor*, from paying on other bonds without paying on the FAA Bonds." Thus spoke, with apparent clarity, the United States Court of Appeals for the Second Circuit in *NML Capital Ltd v The Republic of Argentina* on 26 October 2012 (see our briefing entitled *Sovereign pari passu clauses: don't cry for Argentina - yet* for more background and details).

There had long been a debate about whether *pari passu* clauses of this sort should be given a ranking interpretation or a payment interpretation (though, of course, the proper interpretation turns upon the drafting of each individual clause). The ranking interpretation only required sovereign debt to rank equally with other relevant debt. The sovereign could not do anything that might subordinate the debt below other debts, such as allocating foreign currency reserves to another debt.

The payment interpretation went a step further. Not only must there be equal ranking, but the sovereign must also pay its creditors equally. This was most graphically expressed by Professor Andreas Lowenfeld: "A borrower from Tom, Dick and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If there is not enough money to go round, the borrower faced with a *pari passu* provision must pay all three of them on the same basis." In other words, a sovereign bound by such a *pari passu* clause is obliged not only to ensure that its bonds rank equally but it is also obliged to pay its creditors equally (even if it means that none is paid in full).

In *NML Capital*, it appeared that the New York courts had come down resoundingly on Professor Lowenfeld's side of the argument. Holdout creditors had always been able to obtain judgments for their debts and then to try to enforce those judgments - never easy against sovereigns. The payment interpretation of the *pari passu*

Key issues

- Payment of other creditors may no longer on its own breach a *pari passu* clause
- Action by the sovereign relegating bondholders' rights may be required
- This more restrictive interpretation of a *pari passu* clause may reduce the influence of holdout creditors
- The increasing use of CACs in sovereign bonds similarly facilitates sovereign debt restructuring

provision potentially offered new remedies, in particular injunctions to obstruct the sovereign's payments to other creditors through the US or US institutions. This would enable holdout creditors to bring greater pressure on the sovereign by challenging payments to creditors who had accepted a restructuring deal, as well as payments to other creditors. Restructuring potentially became

more difficult. This in turn generated a number of policy initiatives to try to reduce the impact that holdout creditors might otherwise have (see our briefing entitled *New ICMA sovereign collective action and pari passu clauses*).

All change

But the outlook may now be different. In *White Hawthorne LLC v The Republic of Argentina* (22 December 2016), Judge Thomas P Griesa, whose first instance judgment was upheld in *NML Capital*, has reinterpreted the position. The sovereign was the same, the *pari passu* clause was the same, and the argument was simple: "[i]n short, plaintiffs allege breach due to the Republic's decision to pay *other* creditors while plaintiffs hold out for a better deal", ie payment to any creditors but not, at the same time, to the holdout creditors was a breach of

payment to other creditors, constituted the breach of the *pari passu* clause in *NML Capital*. Argentina's "extraordinary conduct" at that time made it a "uniquely recalcitrant debtor". The key to *NML Capital* was the overall pattern of Argentina's behaviour at that time - its "entire and continuing course of conduct" - not just the payments to other creditors.

Then came Argentina's election in November 2015, which "changed everything". The judge recognised that Argentina's new government had displayed "courage and flexibility in stepping up to and dealing with this long festering problem which was not of their making", that it desired to resolve the disputes, and that it had repealed the lock law. Settlement had been reached with the plaintiffs in *NML Capital* and the injunction granted in that case lifted.

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the holdout creditors' rights under the *pari passu* provision. The decision in *NML Capital* might have offered the plaintiffs hope of success. However, Judge Griesa held that the plaintiffs' allegations were not, on their own, enough to demonstrate breach by Argentina of the *pari passu* clause.

The judge looked at the earlier decisions and other cases in the Second Circuit, and decided that it was Argentina's "lock law" (which prohibited payments on Argentina's defaulted bonds) and the "incendiary statements by the former administration" that, coupled with

In the light of this, the previous Argentine government's conduct was "ancient history and... no longer occurring". All that was left was Argentina's payment to other creditors while not at the same time paying its holdout bondholders. That was not, in the judge's view, enough on its own to breach the *pari passu* clause.

Rights and remedies

In his opinion in *White Hawthorne*, the judge went further and decided that, even if he had found Argentina to be in breach of the *pari passu* clause, that breach did not give the holdout creditors a claim in damages. The

holdouts were entitled to be paid the sums due to them under their bonds, but they did not suffer any loss over and above that non-payment. Their financial remedy was confined to enforcing payment of the sums outstanding on their bonds.

More significantly, the judge also pointed out that the holdouts had no right in law to an injunction to prevent breach of the *pari passu* clause. An injunction "is an extraordinary remedy that is not normally available for breach of contract". The court had already lifted the injunction granted in *NML Capital* in the light of the changed circumstances, and reimposing it would, the judge considered, be unwarranted.

The court also held that the normal six year limitation period under New York law applied to both principal and interest outstanding on the sovereign bonds in question. The limitation period started on the day each interest instalment fell due, with the result that a plaintiff could recover only those interest payments that fell due within the six years prior to commencing the action. So far as principal was concerned, the limitation period ran from the date the bond matured or, if earlier, the date it became due and payable following acceleration.

Conclusion

The long history of Argentina's engagement in the New York courts forms important background to *White Hawthorne*. For many years after its 2001 default, Argentina defied numerous judgments and other court orders made against it. But that changed on President Macri's election. Argentina has settled with most, but evidently not all, of its holdout creditors. Argentina has successfully re-entered the international capital

markets. When some of the much-diminished number of holdouts sought to deploy again the *pari passu* clause to bring pressure on Argentina to meet the holdouts' demands, the New York district court was no longer in such a creditor-friendly mood. Instead, Argentina was rewarded for coming in from the cold and its engagement, on the urging of the court, with its creditors. The remaining holdouts now felt the chill.

This apparent change in legal direction will be welcomed by many in the sovereign debt restructuring arena because it potentially reduces the ability of holdout creditors to frustrate deals agreed by the majority of creditors. Collective action clauses can achieve the same by allowing a majority of bondholders to bind the minority, and these clauses have been included in a significant number of recently issued sovereign bonds (see the IMF's *Second Progress Report on inclusion of enhanced contractual provisions in international sovereign bond contracts*, January 2017).

Absent that constraint, *NML Capital* had opened up the possibility of holdout creditors stepping in to prevent payment to those who had accepted a restructuring, thereby rendering restructuring much more difficult to achieve - at least, so far as New York law governed bonds were concerned (the position for English law bonds was not necessarily the same: see the Financial Markets Law Committee's papers on the interpretation of sovereign *pari passu* clauses governed by English law, March 2005 and April 2015).

White Hawthorne restricts, but does not remove, the power of holdout creditors. Holdout creditors can still refuse to participate in a restructuring

and obtain judgment for the debts due to them. But enforcing judgments against sovereigns is difficult, even with the benefit of a waiver of sovereign immunity. The extra tool - the *pari passu* provision leading to an injunction - that *NML Capital* offered may now prove more difficult to utilise unless also coupled with a blatant display of defiance by the sovereign towards its holdout creditors' rights.

Sovereign debtors involved in restructuring can, it seems, now choose to pay one creditor rather than another, but they will need to be more cautious over what else they say and do. Anything that might be argued to affect the ranking of a payment obligation, whether *de facto* or at law, could still infringe a *pari passu* provision even on the *White Hawthorne* interpretation of the clause. Silently paying some creditors but not others looks to be fine - as long as the New York courts don't slide back towards the *NML Capital* interpretation - but more overt rejection of the holdouts' rights may still cause problems.

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